Waking the Sleeping Giant

Recognize patronage dividends for what they are—co-op capital

BY MARILYN SCHOLL, WITH JOEL DAHLGREN AND BRUCE MAYER

Creating solutions begins with building the foundation for the future you want. One of the remarkable things about cooperation is that mutualism encourages solution-oriented growth, built on a vision of the common good. How profitability and capitalization are handled in cooperatives is an indicator of how much the co-op is actively taking advantage of the opportunity to develop its potential.

For far too long, consumer co-ops have underutilized the potential of the patronage-dividend system to provide capital for the cooperative and fulfill its mission. Most cooperators know that profits generated with members can provide a tax shelter and that patronage refund checks raise member good will. But beyond that, have we as a sector really thought deeply or strategically about what retained patronage equity could be doing for our cooperatives? It's time for us to wake that sleeping giant. Our ability to leave a legacy for the next generations in our communities depends upon it.

Now more than ever, co-ops need a dependable source of capital. And one of the responsibilities of ownership is to provide capital. Retained patronage dividend equity is a way for co-op owners to provide capital without having to put in any additional cash. All they have to do is shop. And the co-op saves taxes!

Why don't more co-ops take advantage of this method of building co-op equity? Let's take a closer look at how your co-op and its board of directors can think strategically about its annual patronage-dividends decisions.

Understanding the value of equity

It's easy to see why there has not been a widespread grasp of the strategic value of retained patronage equity. Quite simply, not everyone understands its long-term value. Historically, the frame of reference for both food co-op management and governance has been that patronage equity belongs to the members and, for that reason, members should "get it back" during profitable years. Compounding this mindset is the fact that the Internal Revenue Service (IRS) requires that patronage equity be allocated to each member, making it feel like it "belongs" to these individuals. What's more, not everyone expects the co-op to make enough profit to distribute or even to reinvest in the business. "Food for people" is a very powerful idea, whereas "profits reinvested in the people's interest" isn't catchy—but it could enhance our ability to change the world.

"Food for people" is a very powerful idea, whereas "profits reinvested in the people's interest" isn't catchy—but it could enhance our ability to change the world.

What the IRS requires (after a co-op board approves a patronage dividend) is that a minimum of 20 percent of the allocated profit be refunded back to the members as a "cash" portion. The cash portion of the dividend can be paid out in a check, voucher or store credit, or it can be given back to the co-op by the member to support its charitable programs. The only imperative is that these checks or vouchers be cashed in order to avoid tax liability on the profits earned from sales to that member. The rest, up to 80 percent, can be withheld as retained patronage equity in the cooperative.

> **Heres a sample motion that documents the board's annual decisions:**
>
> I move that the co-op allocate 100 percent of eligible profits to patronage dividends ($XX,XXX) to members and that 20 percent of those patronage dividends ($X,XXX) be distributed to members in the form of a store credit and according to rules outlined by Internal Revenue Service Chapter T and the state laws. Any distribution that would be less than $2.00 shall not be distributed and the related profits shall not be allocated.

The legal and financial reality regarding this money is twofold: Unless a co-op officially and explicitly states it, the co-op is not required to return any profits to the members, nor is it ever obligated to pay out retained patronage equity. Until you have taken a class of patronage and declared it payable, it is not owed to anyone until the board declares an obligation. If no declaration is made, the funds can remain in the co-op in perpetuity. If the co-op ever decides it has too much capital and has no vision or plans that would require capital, then the retained patronage could be returned to members. Although this is generally true in most states, it is also important to obtain professional legal and financial advice from experts knowledgeable about cooperatives on how your co-op can

ILLUSTRATION BY MELECK DAVIS

properly handle profits and retained patronage equity in your jurisdiction.

Given today's economic climate, retained patronage equity represents an outstanding opportunity to build capital for the co-op that is not leveraged by outside financing, as well as an opportunity to enhance the co-op's balance sheet for times when it does need to borrow. As banks become more conservative and capital harder to raise, co-ops can take matters into their own hands and build capital with retained patronage dividends.

That the business can be capitalized through the profits from the patronage of its owners is another one of the impressive things about cooperation—individually, owners don't need great sums of money to provide for their business. The owners' pooled resources through patronage equity can do a lot of heavy lifting in capitalizing the business. Looked at this way, retained patronage equity is not for the individual owner at all and shouldn't be considered as such. It is everyone's money, set aside for the good of the cooperative.

Of course, there is a balance that must be struck, and thinking about what's best for the co-op should take precedence. It's not necessarily prudent to hang onto the members' money in perpetuity, which takes us back to those tax advantages and the idea that patronage dividends tangibly demonstrate ownership in the co-op. However, annual decisions about what to do with co-op profits should be made in the context of the long-term needs of the co-op and what outcomes members expect the co-op to deliver.

The potential for retained patronage equity capital is huge. Of over 100 co-ops in the Common Cooperative Financial Statement (CoCoFiSt) database, only 29 co-ops show retained patronage on their balance sheets. The range reported is from $5.1 million to $3,677. The average amount of those with retained patronage dividends is $494,000 and the median is $165,000. Five co-ops have over a million dollars in retained patronage equity.

What if all 100 co-ops had a half-million dollars in retained equity? That would be $50 million in equity, giving the food co-ops, as an aggregate group, much more control over their future destiny. Clearly, if our sector focused on ▶

Fresh, Organic & Delicious
SINCE 1983

95%+ ORGANIC
GLUTEN FREE
NO PRESERVATIVES

Emerald Valley Kitchen Organic

PRODUCTS OF THE USA
www.emeraldvalleykitchen.com
5% of Sales Donated to Humanitarian & Environmental Projects
USDA ORGANIC

Harvest your co-op to co-op relationships.

Join NCBA, the only national cross-sector cooperative organization, and leverage your co-op to co-op marketing capabilities. For more information, visit us at www.ncba.coop or call us at 202-638-6222.

strategically and systematically building retained patronage equity, it could see enormous benefit.

Annual decisions

Every year, the question comes up—what do we do with our profits? Since it is an annual decision, being prepared for it will enhance co-op leadership's ability to think about it strategically. Before determining how much of eligible profits should be allocated for any potential distribution, addressing the question of what the co-op's long-term needs are is imperative. This is not a once-a-year talk, but part of an ongoing dialogue. The ideal board conversation about this would start with the co-op's long-term objectives and how the co-op's capital needs are connected to any patronage dividend or retained-equity decision.

Does the co-op plan to expand and build its balance sheet? What activities do owners want the co-op to support? Does the co-op have debt and want to lower its risk? It's wise to assume that the co-op will need capital to pursue business opportunities. When you are focused on your long-term plans, the questions about what to do with the co-op's profit and retained patronage equity become much clearer. It becomes a matter of process and taking best advantage of the opportunity to either distribute or retain earnings.

Decision #1: How much of the eligible profits should be allocated?

After you have calculated profit that is eligible for allocation and determined whether there is a reason not to allocate all eligible profit, you can move on to the following considerations:

- **Are all profits eligible for distribution?** Some state laws allow profits allocated to all patrons to be tax-exempt for the cooperative. Most food co-ops restrict patronage allocation to members only. Profits on nonmember sales cannot be distributed to members and will be taxed.
- **Does the co-op need to build a cash reserve?** Some state laws and bylaws allow a percentage of profits on member sales to be set aside to build reserves. For many co-ops, the after-tax profit on nonmember sales will build adequate cash reserves.
- **Tax implications.** If the co-op has other available tax deductions (such as prior losses or investment tax credits) that are more valuable than patronage dividends, the co-op may allocate less than 100 percent of eligible profit to reduce the cash outlay of the 20 percent distribution requirement.
- Always consider **state law** requirements.
- Unless there is a compelling reason not to, we recommend **allocating 100 percent of eligible profits** for patronage dividends.

Decision # 2: What percentage of the allocated profits will be distributed?

- The minimum **required by the IRS is 20 percent**. Determine if there is any reason to distribute more than what's required.
- **Cash needs**. Does the co-op have long-term debt or other liabilities that will need to be repaid? If so, conserve cash by distributing the minimum amount.
- **Capital investment needs**. Does the co-op have a vision or strategic goals that will require future capital investment? If so, conserve cash by distributing the minimum amount.
- **Balance sheet strength**. Does the co-op have expansion or other plans that will require outside capital? If so, strengthen the balance sheet and the co-op's ability to leverage debt capital through retained patronage equity—conserve cash by distributing the minimum amount.
- **Fair return to members**. What is a fair return to members? While patronage dividends are a return on purchases, not a return on a member's equity investment, co-op boards often find it helpful to compare the cash portion of the dividend with the return on other possible investments such as a savings account. For example, if the member equity investment is $100, a goal for cash distribution could be $5–$10, significantly higher than what would be earned in a savings account. If a

FAMILY OWNED & OPERATED SINCE 1960
CELEBRATING 50 years 1960-2010 SPRINGFIELD CREAMERY
Nancy's®
Organic Yogurts – offering billions of live, healthy probiotics per spoonful.
Enjoy!
USDA ORGANIC
Certified Organic by Oregon Tilth
K DAIRY
nancysyogurt.com

Meet one of our favorite cooperative developments.

Thousands of programmers all over the world (including us) are working cooperatively on an open source solution for building websites. It's called Drupal. Find out why an increasing number of organizations, businesses and government agencies (whitehouse.gov) are adopting it as their website platform. We've found that its community-building features work especially well for cooperatives.

We know Drupal and we know cooperatives.

Let's build your co-op a great website.
Call Dan Nordley, 612/436-9177
dan@triangleparkcreative.com

TriangleParkCreative | design for a cooperative world
TriangleParkCreative.com | Identity Print Web Packaging

co-op member spends $100 each week and the co-op earns a net profit of 2 percent, that member's allocation would be $104 and the cash portion would be $20.80. Actual dividends will vary widely depending on profitability, the portion allocated in cash, and the member's total purchases.

• **Member needs and expectations**. What do members want from the co-op? What capital will be needed to provide that?

• **State law requirements**. Be sure you are current and in compliance.

• **Building capital**. Unless there is a reason to distribute more, or the co-op has all the capital it will need in the foreseeable future, we recommend distributing the minimum amount (20 percent) of allocated patronage dividends.

Decision # 3: What is the method of distribution, and what minimum amount will the co-op be distributing?

• **What method encourages use?** If members don't cash their refund checks or use their refund credits, the co-op will owe taxes on the full amount of their allocations (both the distributed and retained portions). Store credits, especially those that can be implemented through the POS system, are more likely to be used. Members must be given the option of getting their patronage dividend distribution in cash.

• **What is the cost of distribution compared with the value to the co-op and to the member?** What does it cost to prepare and mail checks or allocation notifications? Set the minimum amount of distribution so that the cost is not greater than the distribution amount. Remember that the tax implications are on the entire amount of the allocation, not just the distributed amount.

• **State law requirements:** Be sure you are current and in compliance.

• We recommend setting a **minimum distribution amount between $2.00–$5.00** and using store credits if allowed in your state.

Putting it into practice

Food co-ops around the country are thinking strategically about patronage dividends. Following are a few examples.

In 2008, the board of directors of Lexington Co-op in Buffalo, N.Y., decided to eliminate its member discounts and institute sustainable, flexible member benefits. The core of the new benefits program was a patronage-dividend system that would build up profits as well as equitably distribute profits. The co-op has a large debt load for its size, and when they looked to the future, the board felt the co-op needed much more growth in equity to continue to meet the owners' needs. Other new benefits available only to co-op owners include monthly specials, everyday low prices on basic food items, and case order discounts.

Almost immediately, the co-op felt its impact on the bottom line, and member reaction has been overwhelmingly positive.

> In a database of over 100 food co-ops, only 29 co-ops show retained patronage on their balance sheets.

As part of the process for making this change, co-op leadership had to address its own fears that the members would be unhappy with the change. "We had to approach it from what would be sustainable for the co-op and worthwhile for the members. We had to change the things that were not working," said General Manager Tim Bartlett. The co-op's first patronage dividend included all profits on member sales and a 20 percent cash distribution with a $1 minimum. Members who spent an average of $53 per week received a $10 patronage dividend check. That's in addition to great member specials throughout the year. Board President Amy Holt added, "I think our members understand the co-op better and see it as a different business. They can see how they benefit when the co-op succeeds."

At the Wedge Co-op in Minneapolis, Minn., it wasn't until the 1990s, when the co-op started to consider the potential impact of retained patronage equity on its business, that things really came together for the co-op, according to Financial Manager Elka Malkis. "You can't do other things without being successful as a business, and patronage refunds and retained equity are part of the model of cooperation," Malkis said.

The Wedge Co-op board also established guidelines for determining how much would be retained and how much would be distributed to members. "Before that, it was pretty subjective," Malkis said, but when the board realized the importance of the capital, they knew they had to safeguard it by developing a strategy and course of action for it.

Currently, the Wedge Co-op's retained patronage equity stands at $5.1 million. That's an inspirational number, to be sure, but Malkis is clear that the retained equity level is the result of years of foresight and planning and the commitment of the co-op's 14,000 members. And it's not a big pile of money sitting around in a bank account. That money has been busy! Over time, the retained patronage equity has served as a nest egg and a way to raise capital for the co-op's warehouse, online store and organic farm.

Both Malkis and General Manager Lindy Bannister said they see retained patronage equity as the co-op's legacy to the community. "We're not just about bringing people groceries. There's so much more to what we are doing with our members' money, and it benefits them in different ways," Bannister said.

Whole Foods Co-op in Duluth, Minn., has traditionally not distributed amounts under $5, choosing instead to pay taxes on those profits. This year, however, the co-op decided to reach out to those members whose purchases were so small that they would not receive a distribution. The co-op sent even the smallest of refunds and offered those members a 5 percent discount if they cashed the check toward a purchase at the co-op. The offer got members back in the store, and sales currently are growing in double digits.

Creating solutions is what co-ops are all about. By thinking strategically about patronage dividends, your co-op can build the capital it needs to accomplish its dreams. At the same time, you can communicate to co-op owners what cooperative ownership means! Member owners get a fair return, the co-op gets the capital it needs to better serve members' needs, taxes are reduced, and more money stays in your community. What's not to like? ■

When is Borrowing also Investing?

When your co-op takes a loan from the Cooperative Fund of New England, you're helping to ensure that financial resources are available to future co-operators. We also welcome your investment.

COOPERATIVE FUND of New England

CFNE is a socially responsible investment option.
web: www.coopfund.coop • tel: 1-800-818-7833

Keep your policymakers in the know

with a subscription to the Cooperative Grocer for each of your board members.

See page 3 for a subscription form.

Cooperative Grocer
FOR RETAILERS AND COOPERATORS